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DEVELOPMENT OF RURAL FINANCIAL SERVICES: SUGGESTIONS FOR NGOs IN BANGLADESH

by

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INTRODUCTION

Many countries are attempting to improve the financial services provided to rural people. The Bangladesh experience in rural finance is especially relevant for three reasons. First, it has largely completed the first step in the process of financial development, namely the expansion of the bank branch network into rural areas. Second, more international and domestic NGOs are involved in rural finance than in most other countries. Third, an exceptionally large amount of experimentation is taking place ranging from large projects to reform the major banks to smaller ones providing financial services in a few villages. Noteably, the Grameen Bank experiment is becoming one of the best known projects in the world providing finance to the poor.

Financial Intermediation

To appreciate what should be the long-term objective of rural financial development, it is necessary to recall the basic nature of financial services. Financial markets link surplus units (households, businesses, etc.) with deficit units. Units with temporary financial surpluses lend them to deficit units and in return take some type of financial security (IOU, note, mortgage). With loans, deficit units gain by undertaking investments that they could not make without the additional resources. The surplus units gain through the option making a financial investment rather than being limited to only physical investments.

Direct lending occurs in several ways, such as when a moneylender lends to a farmer. Some of the limitations of direct lending can be reduced when financial institutions are created to intermediate between surplus and deficit units. This fact gives impetus to the development of rural financial institutions and markets.

Unfortunately, many rural financial projects ignore the dual benefits of intermediation and only stress the borrowing side of the equation. During the past two decades, most projects have emphasized channelling highly subsidized loans to farmers. Most of the funds have been targeted, that is the amount lent and the end-use of approved loans are specified by the lender and/or central bank. Funds are frequently provided from external sources and few efforts have been made to mobilize local resources. Incentives are provided to meet disbursement targets with little concern for loan recovery.

The limitations of past projects are now clear. Low interest rates create excess demand for funds and force lenders to adopt non-price rationing. Loans tend to go to larger farmers with assets and political clout required for loan approval. Excessive paperwork requirements raise borrowing costs, especially for small loans, and discourage some potential borrowers. Lending institutions frequently run short of funds because they mobilize few deposits, interest rates are too low to cover costs and inflation, and loan recovery rates are low. Many institutions are essentially bankrupt and depend upon continual transfusions of funds from the central bank and donors.

A new approach has emerged to the development of rural financial services. Projects now emphasize providing secure deposit services and mobilizing funds for rural lending. Interest rates are set at higher levels so depositors are rewarded and institutions are better able to cover costs. Targeting is reduced so that borrowers can obtain funds which more adequately meet their needs, and loan recovery is stressed to assure long-term institutional viability.

The Challenge for NGOs

A problem for formal financial institutions such as banks is that operating costs are high and it is expensive to service the large number of small deposit and loan accounts needed by the rural poor. Innovations such as group lending are being tested but it is not clear if they reduce operating costs and default risks.

NGOs are experimenting with ways to provide savings and loan services in rural areas. These services are frequently part of programs designed to generate income and reduce poverty. Frequently, these projects absorb some of the operating costs that otherwise would be borne by financial institutions. A challenge for NGOs is to "graduate" the current project participants so that new persons can be assisted.

NGOs can play an important role by introducing the rural poor to financial services, by educating them about their responsibilities with finance (especially loan repayment), and by graduating them into working with formal financial institutions.

The following suggestions provide guidelines for NGOs that may help improve their success in these programs.

1. Balance the relief and humanitarian objectives of NGO programs with a tough business approach to financial undertakings.
2. Make explicit the costs of subsidizing credit operations and distinguish operating expenses from educational investments.
3. Recognize that reliable and safe deposit services are as important as loan services for rural people.
4. Emphasize self-reliance in finance and establish the principle of "savings first" before providing loans to program participants.
5. Increase the value of the program for participants by stressing flexibility in the amount of money lent and the approved purposes for loans.
6. Maintain good records on loans disbursed, and principal and interest due and recovered.
7. Be firm with loan collections and deny new loans to people with poor repayment records.
8. Design programs so participants gain experience in dealing with financial institutions.
9. Set a clear objective of graduating participants at a predetermined date.

There are several unanswered questions about the development of rural financial services in Bangladesh that should be examined by NGOs as programs are designed and projects evaluated.

1. What are the operating costs of NGOs in providing financial services and what do they imply about the probable costs that formal financial institutions might face in providing similar services?
2. How successful are borrowers when given a greater opportunity to decide upon loan size and use than is permitted in most targeted programs?
3. Do participants in NGO programs retain the positive values learned when they deal with financial institutions after graduation?
4. What form of financial institution should participants graduate to? Banks? Credit unions? Coops? Informal self-managed groups?
5. What problems have been encountered by NGOs in working with financial institutions and how can they be overcome so that graduates can successfully deal with them?